



China's Long March to Retirement Reform

How the Coming Age Wave Will Reshape China's Economy and Society

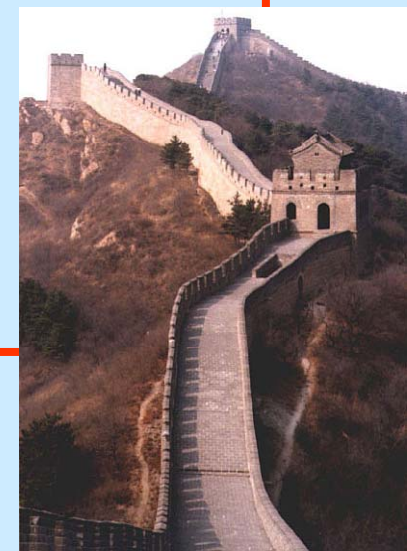
Richard Jackson

Global Aging Initiative

Center for Strategic & International Studies

Washington, DC

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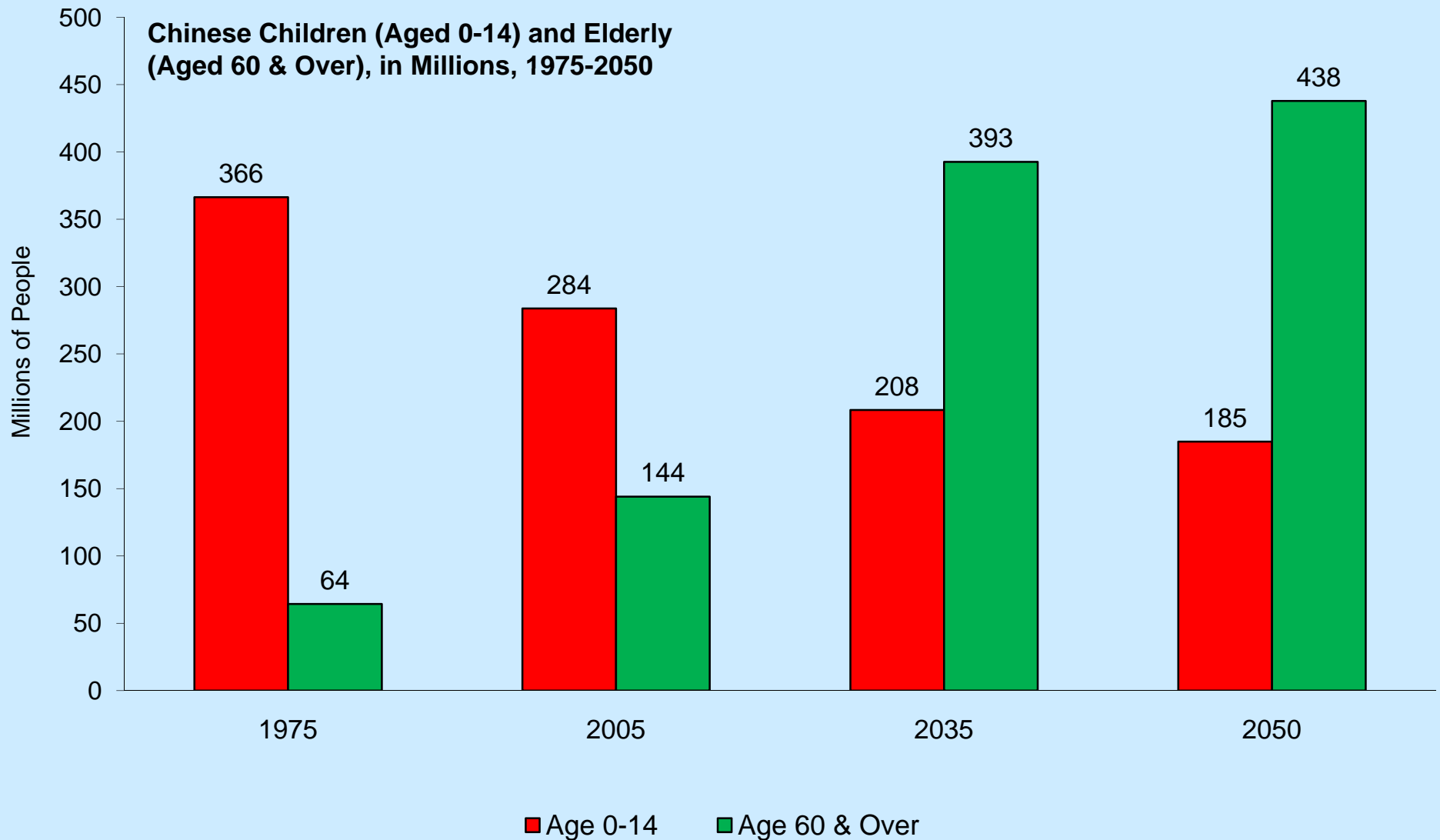




China is still a young nation, concerned with a young nation's challenges—from educating children and creating jobs for a growing workforce to building a modern economy.

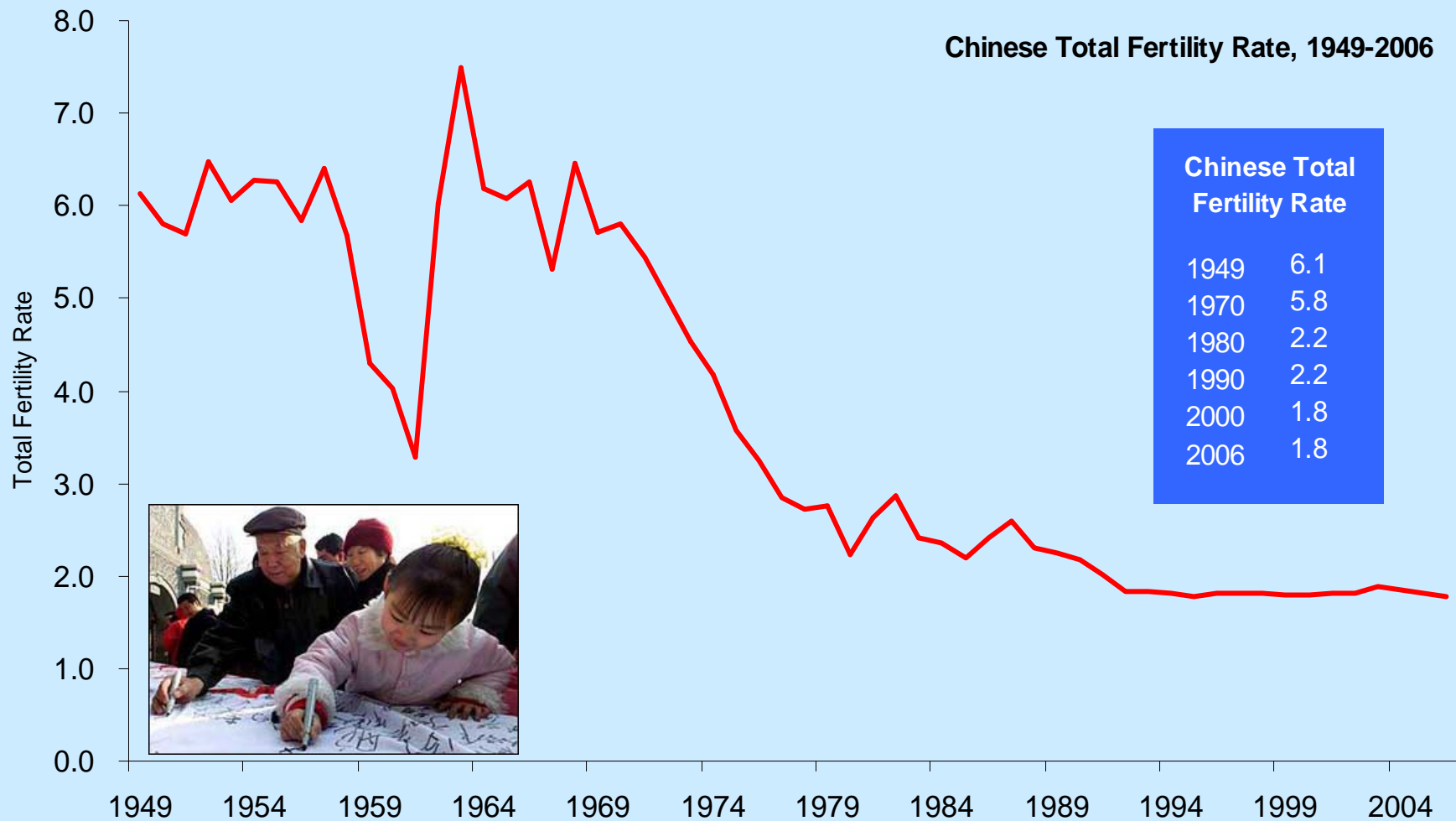
China, however, is about to undergo a stunning demographic transformation.

A young nation is about to grow old.



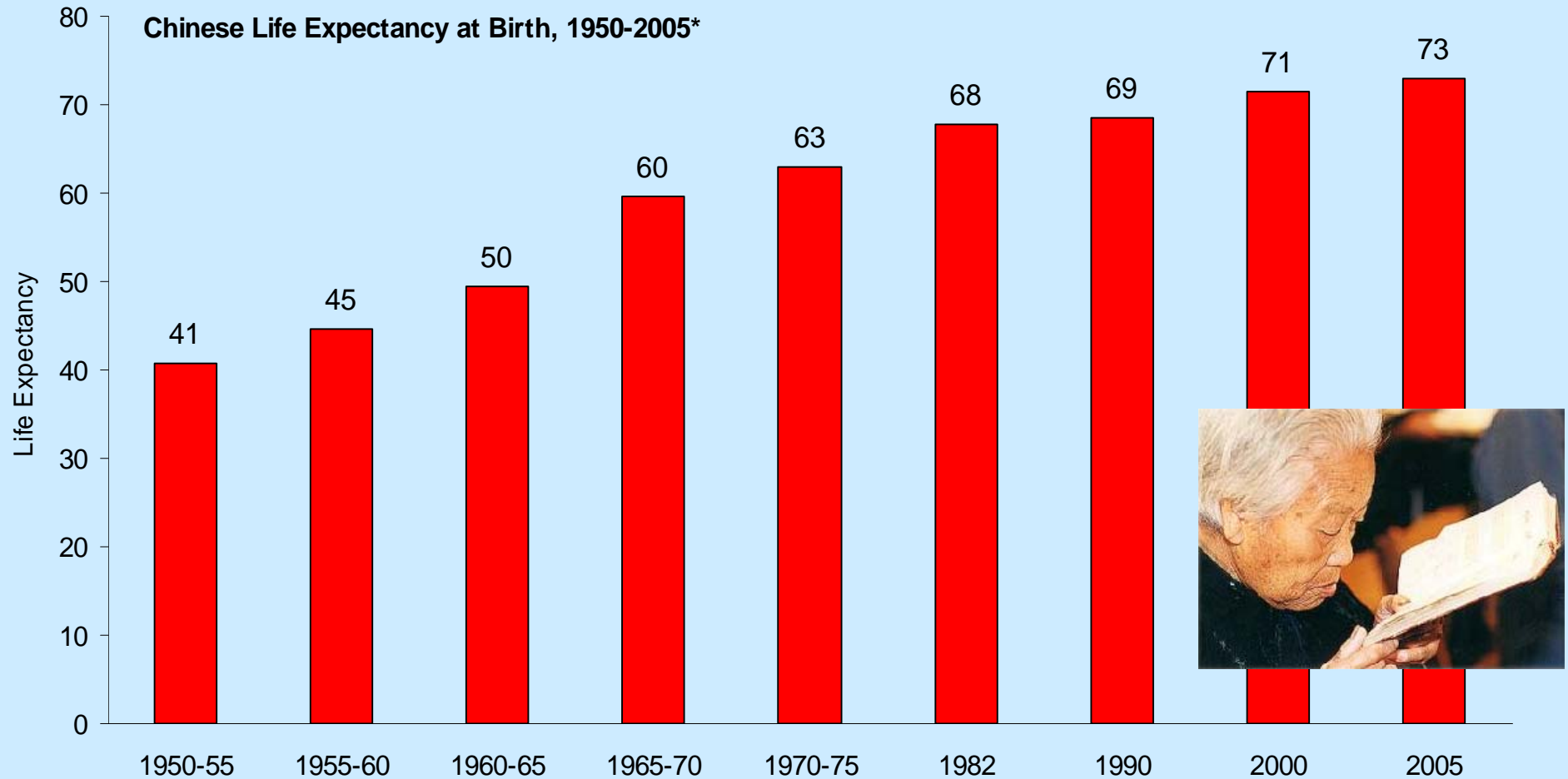
Source: UN (2007)

Behind China's age wave: A dramatic decline in fertility rates.



Source: NPFPC (various years)

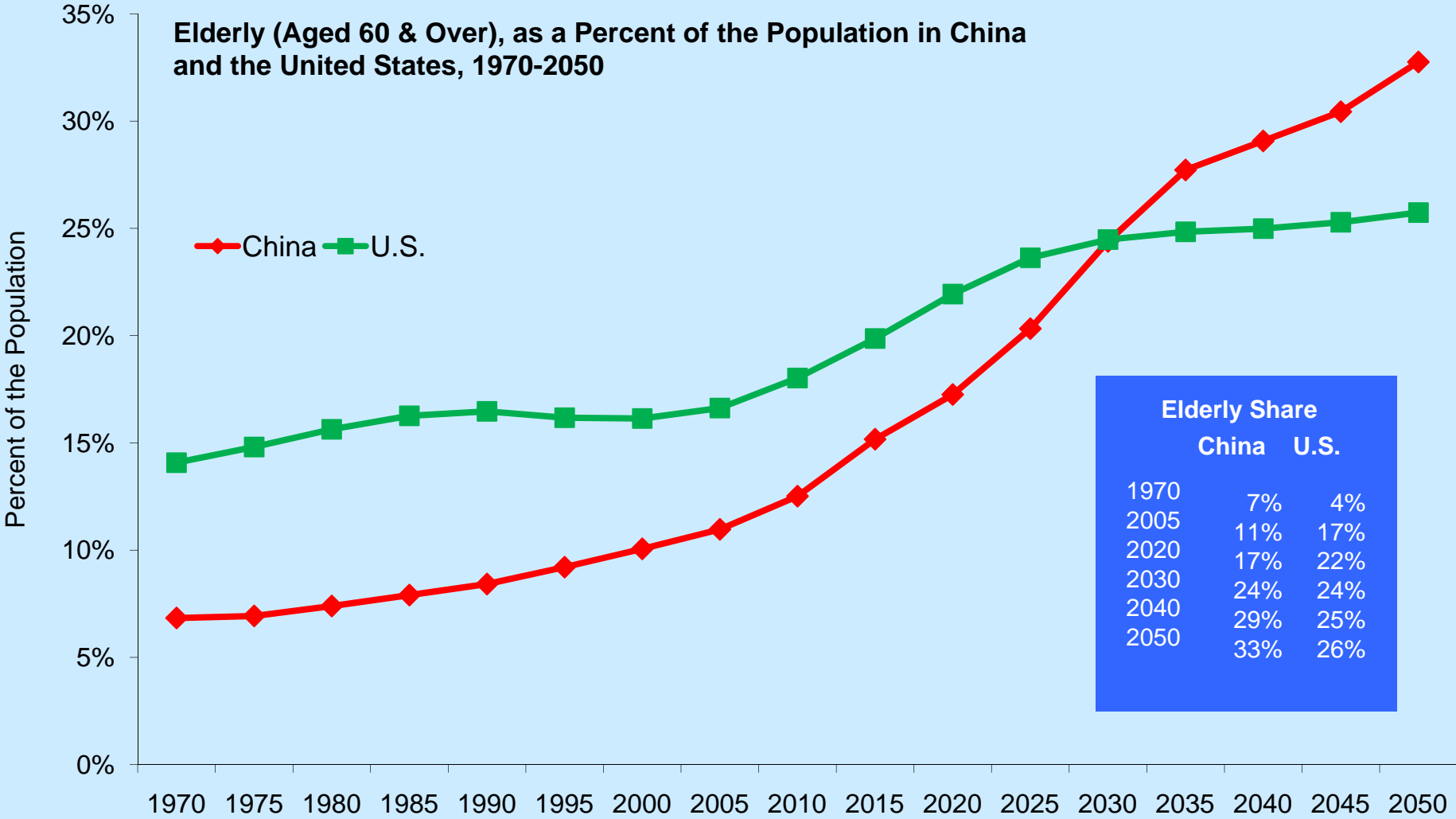
Behind China's age wave: An equally dramatic rise in life expectancy.



*UN five-year average data for 1950-1975 and Chinese census data for 1982-2005.

Source: MOH (2008); and UN (2007)

Within a generation, China will have an older population than the United States.



Source: UN (2007)

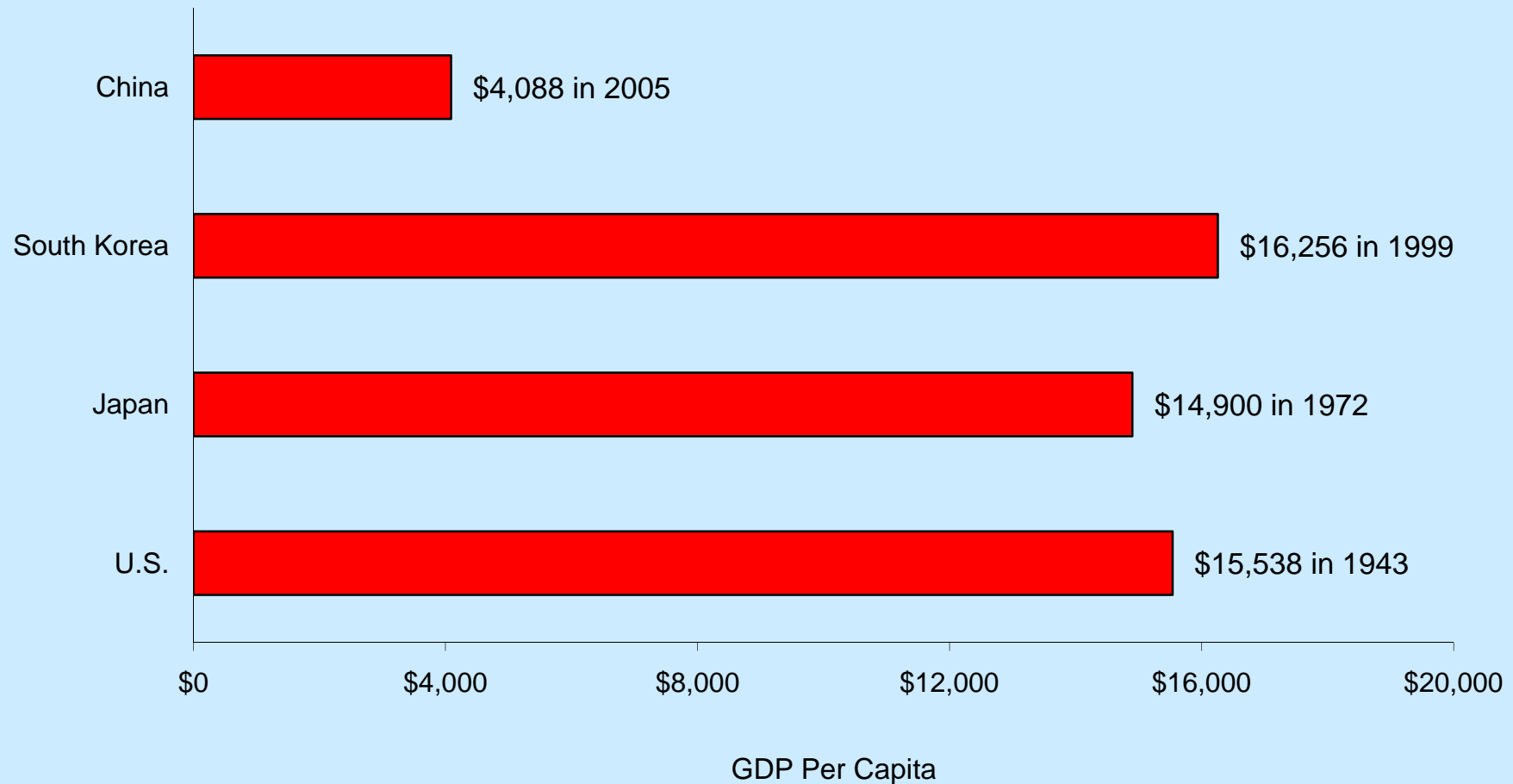


While today's developed countries were all affluent societies with mature welfare states by the time they became aging societies, China's age wave is arriving in a society which is still in the midst of development.



China's "premature aging": A larger elderly population at a lower income level.

GDP Per Capita (in 2005 PPP Dollars) in Selected Countries in the Year They Had the Same Elderly Population Share as China in 2005



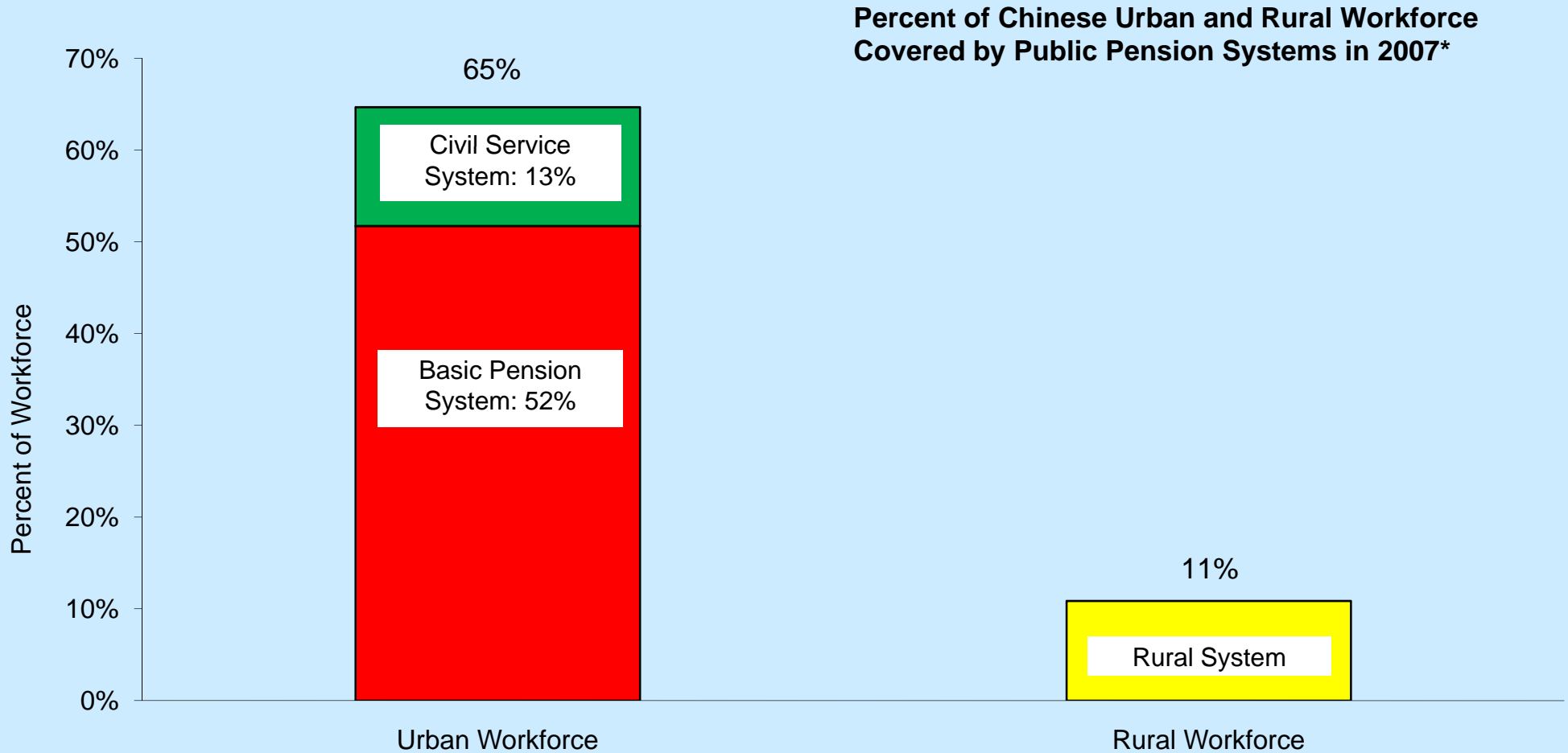
Source: UN (2007); U.S. Census Bureau (2002); World Bank (2008); Maddison (2007); and CSIS calculations



Unless China prepares, a retirement crisis of immense proportions looms just over the horizon in the 2020s.



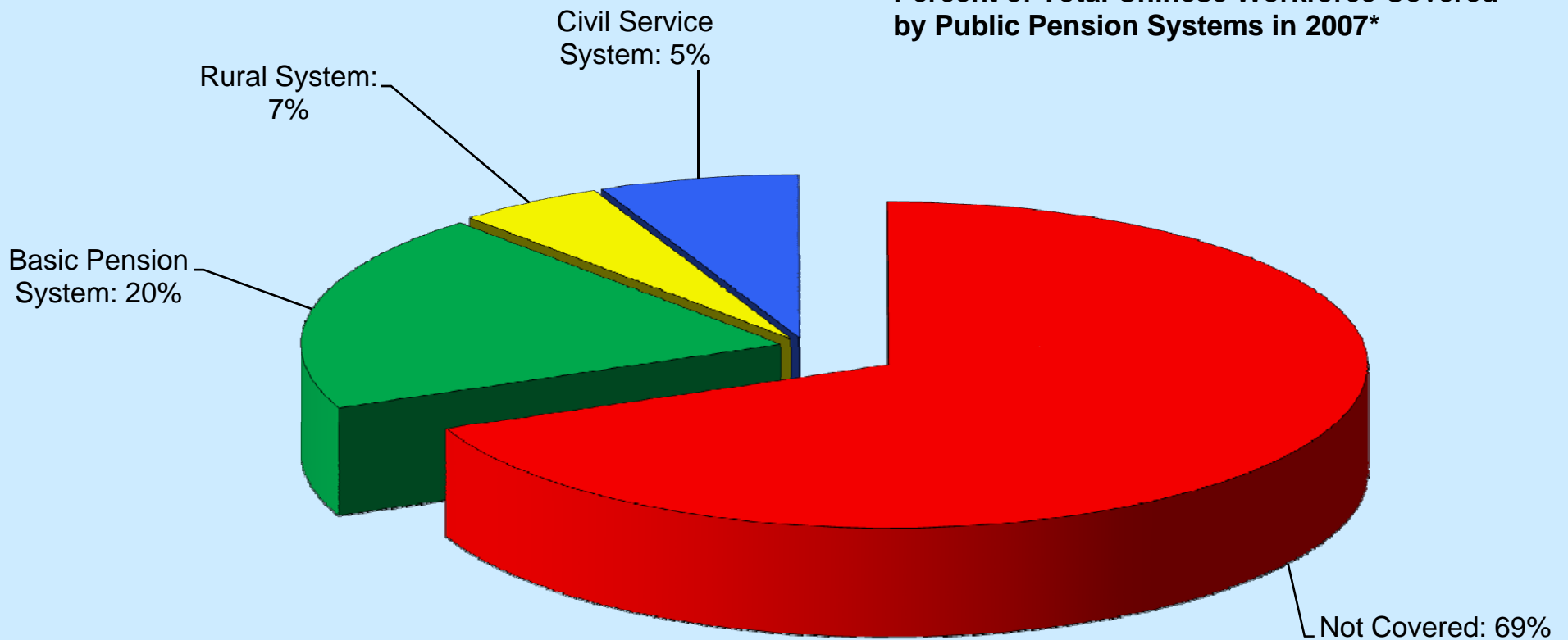
Even in the cities, the public pension system leaves large gaps in coverage.



*Civil Service System data are for 2006.
Source: MOHRSS (2008); and Sin and Mao (2007)

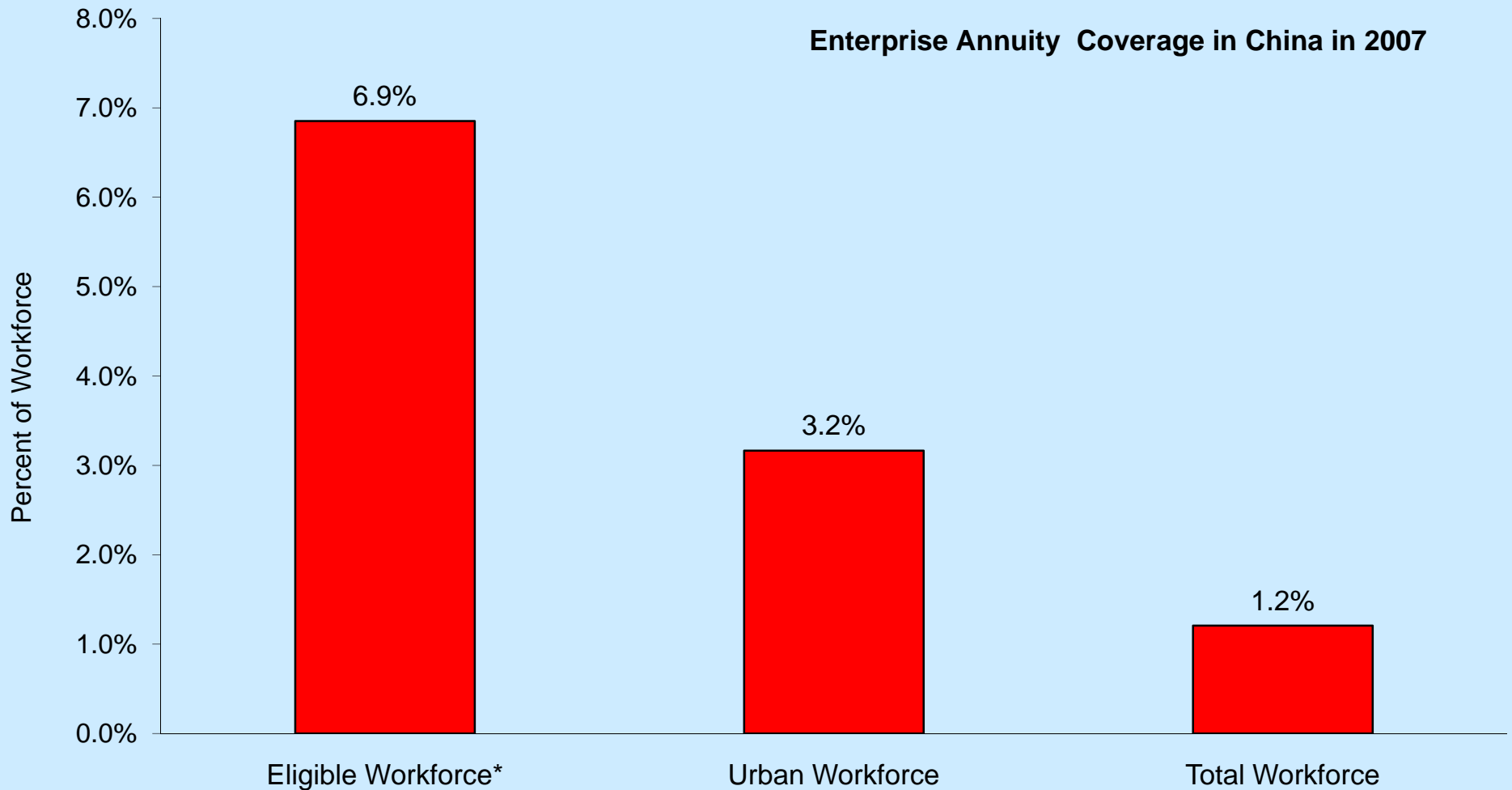
Overall, just three in ten Chinese workers are earning any public pension benefit.

Percent of Total Chinese Workforce Covered by Public Pension Systems in 2007*



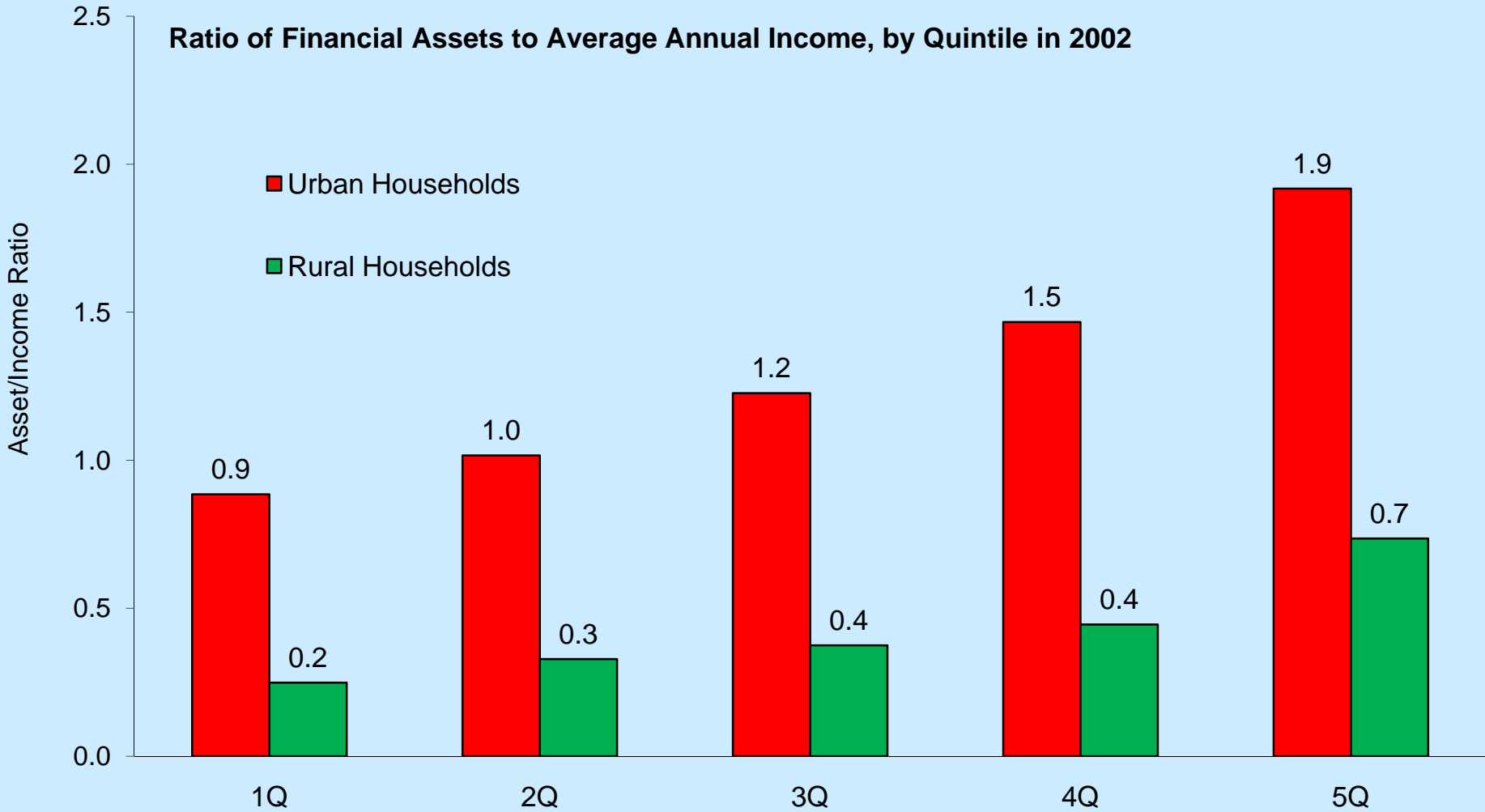
*Civil Service System data are for 2006.
Source: MOHRSS (2008); and Sin and Mao (2007)

China's private "enterprise annuity" system is still in its infancy.



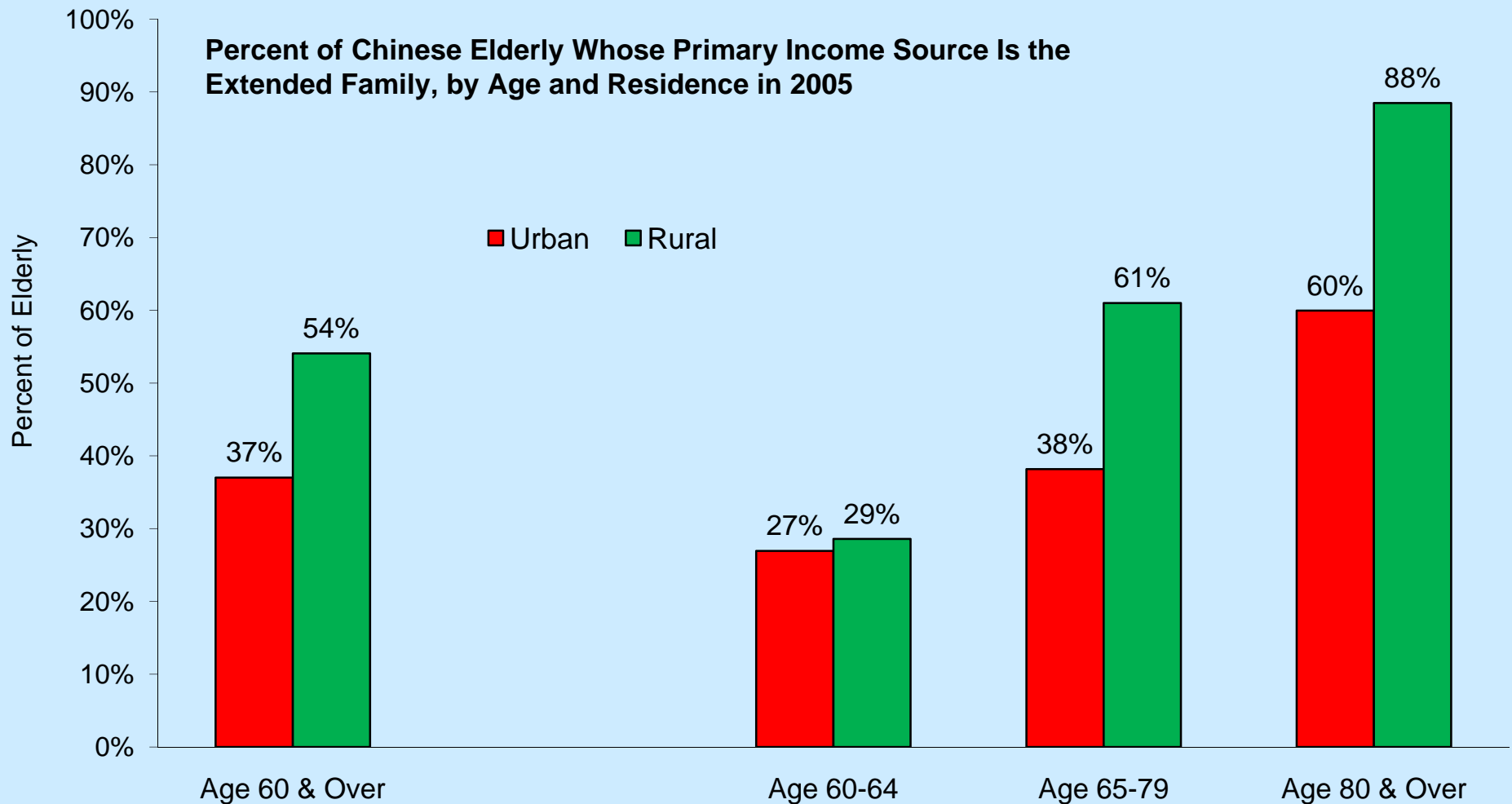
*"Enterprise workers" contributing to basic pension system.
Source: MOHRSS (2008); and CSIS calculations

Few elders will be able to count on personal savings to finance their retirement years.



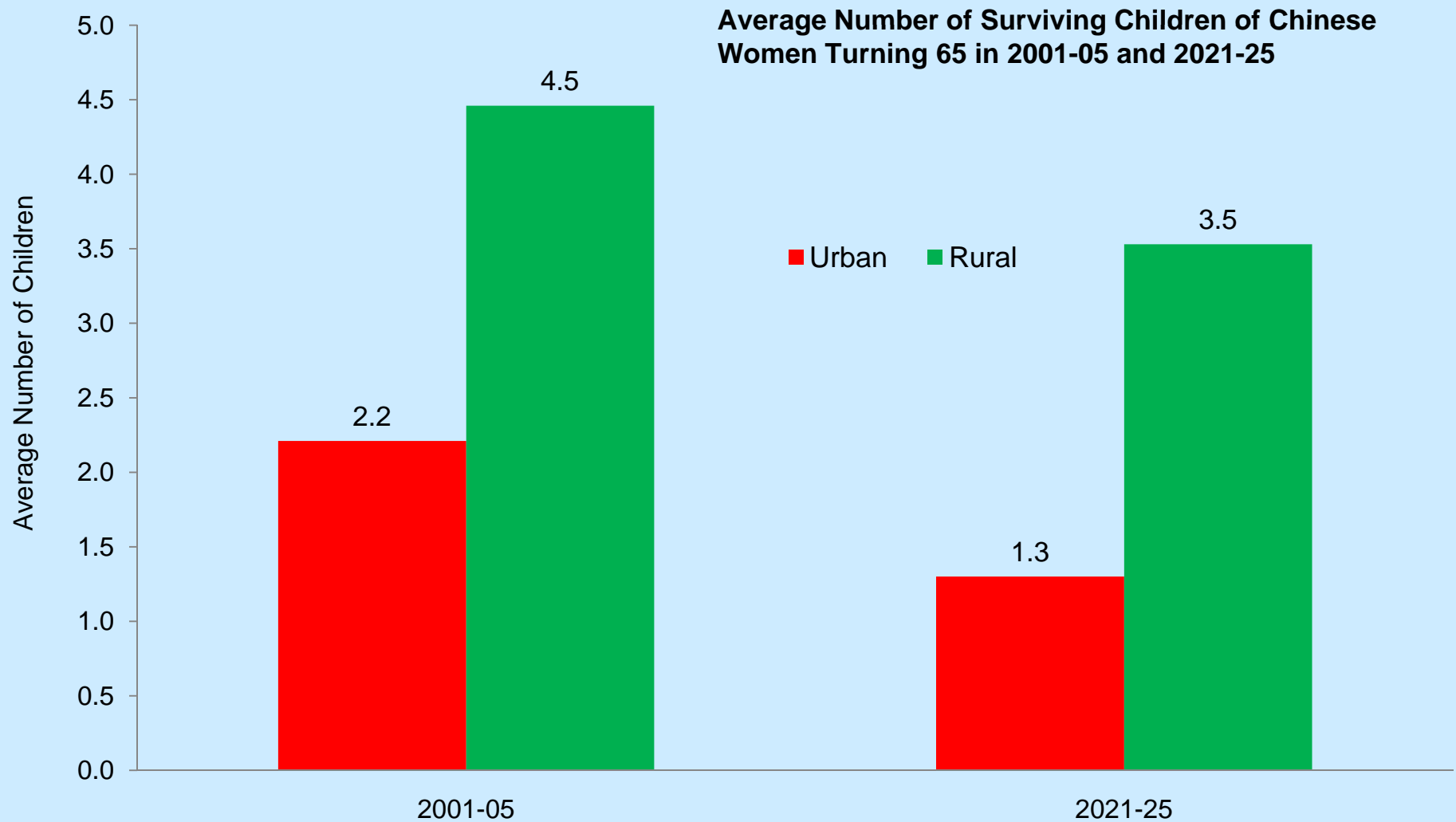
Source: CDRF and UNDP (2005); NBS (2007); and CSIS calculations

A large share of Chinese still depend on the extended family for support in old age.



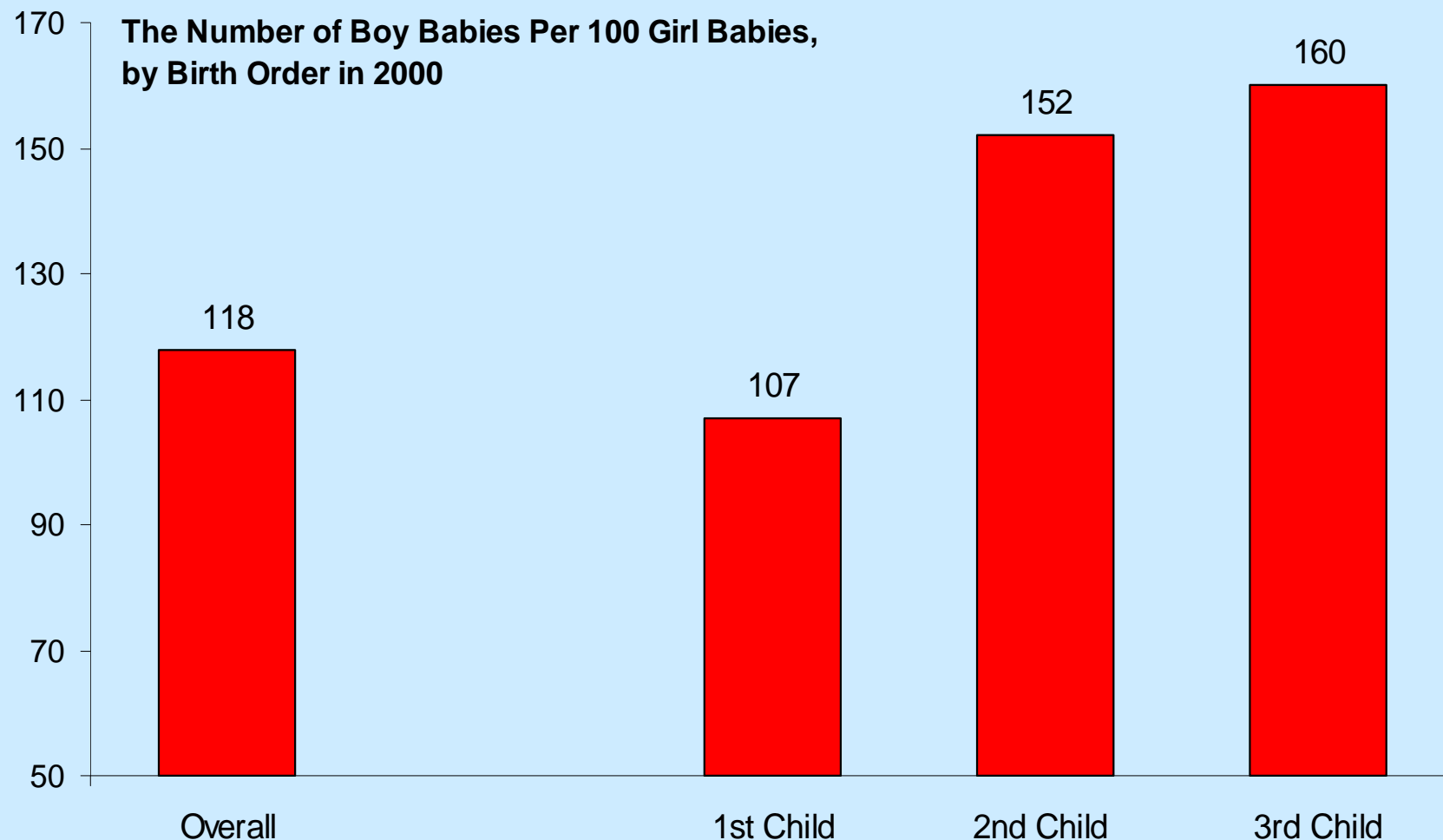
Source: NBS (2006)

Family support networks will be under intense demographic stress.



Source: Qiao (2001)

China's gender imbalance exacerbates the old-age dependency challenge.



Source: NBS (2002)



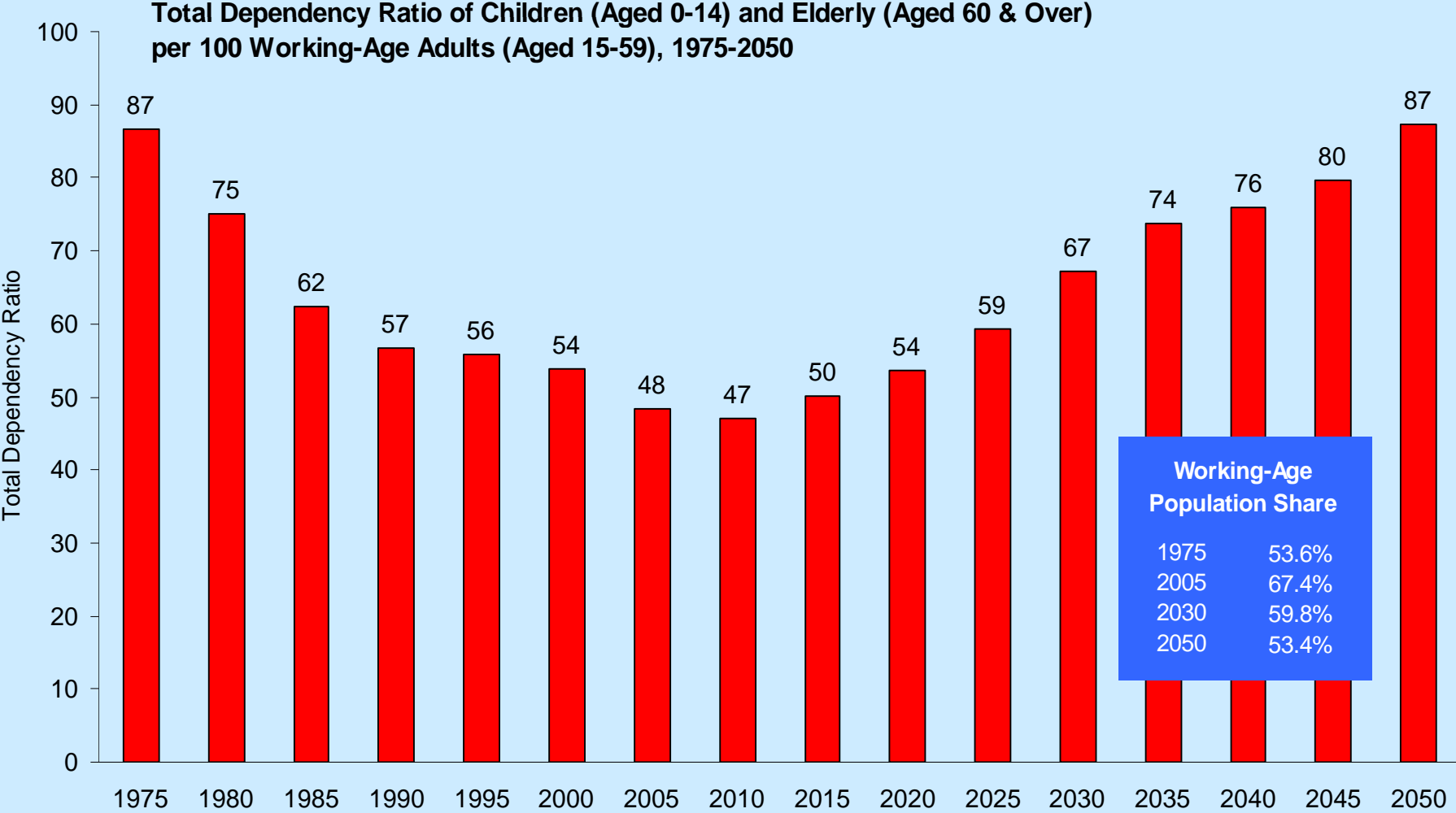
Bottom line: Tens of millions of Chinese are on track to reach old age without pensions and without intact family support networks.

The age wave threatens to act as a multiplier on the social and economic stresses accompanying China's modernization—from mass internal migration and the breakup of the extended family to widening income inequality and environmental degradation.

China's economic development has sometimes been likened to a speeding bicycle that has to keep going just to keep from falling over.

China's aging increases the pressure. On the one hand, it makes rapid economic growth even more important, since workers will have to transfer a rising share of their incomes to nonworking elders. On the other, it makes rapid growth more difficult to achieve.

The end of the “demographic dividend”: Population trends have been leaning with growth, but will soon be leaning against it.



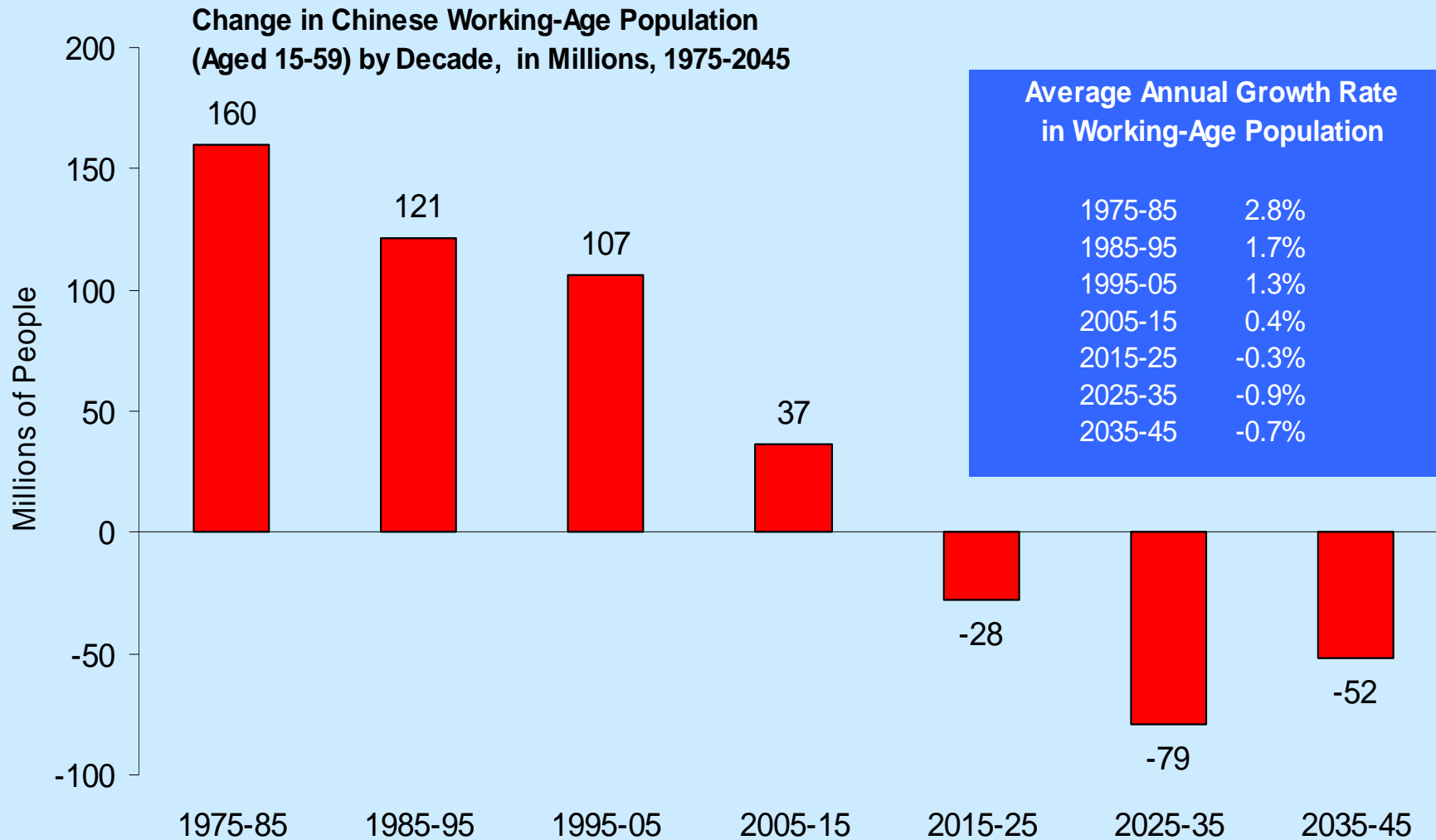
Source: UN (2007)

There will be fewer working-age adults in China to support each dependent elder.



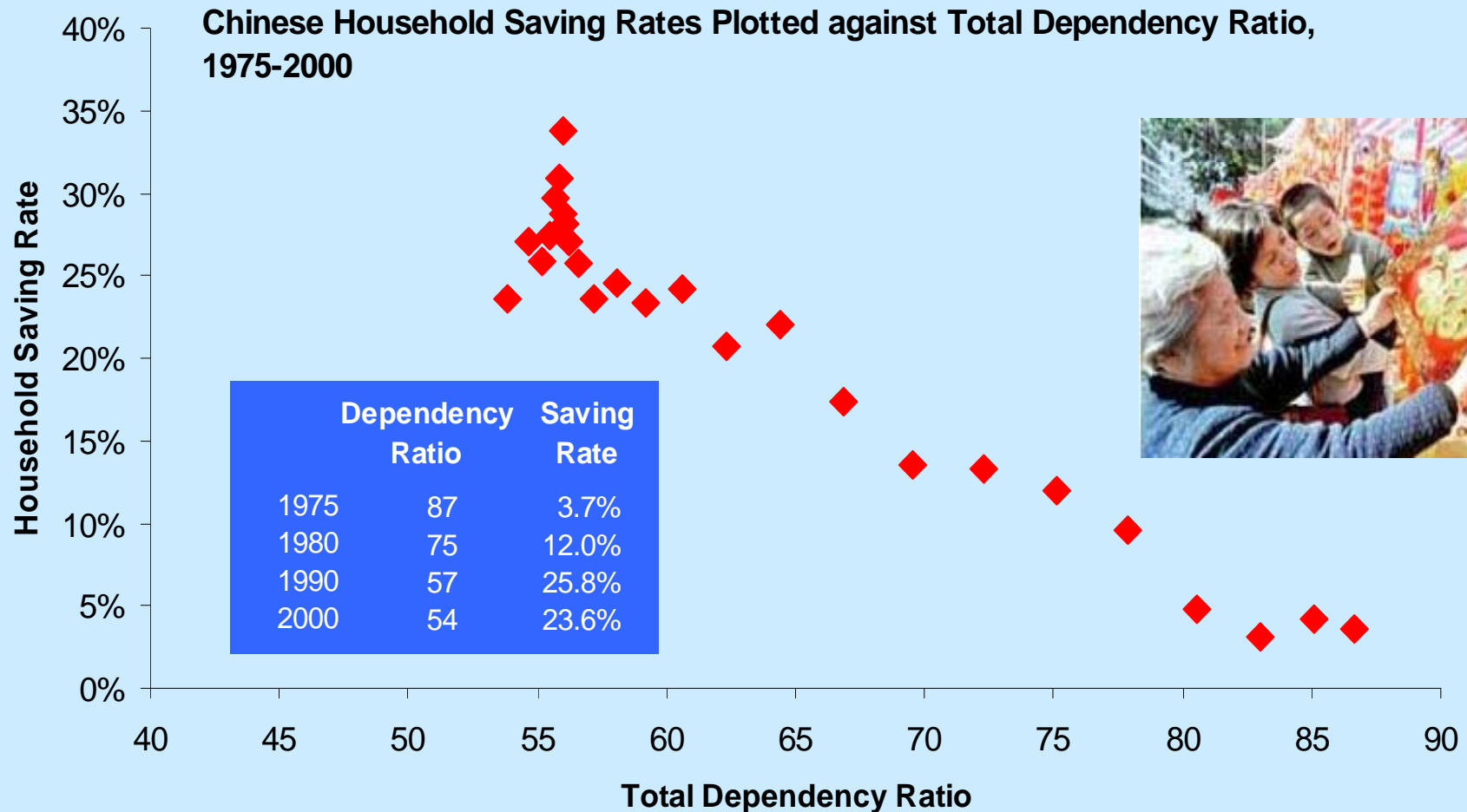
Source: UN (2007)

A contracting working-age population will mean a more slowly growing GDP.



Source: UN (2007)

Savings rates, which have risen dramatically as youth dependency has declined, could fall just as dramatically when elder dependency climbs.



Source: UN (2007); and Modigliani and Cao (2004)

China's continued economic success will depend on the vitality of its capital markets.

- **Most capital in China is still effectively allocated by government through the state-owned banks.**
- **The underdevelopment of China's capital markets has so far done little to hinder growth because much of its spectacular productivity gains have been driven by FDI and mass internal migration.**
- **With developed countries likely to face long-term capital shortages as they age, heavy reliance on FDI is a risky long-term strategy.**
- **As China continues to move up the global value added scale, internal migration cannot continue indefinitely as a source of productivity growth.**



China must adapt a reform strategy that is equal to the magnitude of the demographic challenge it faces.

China's existing "basic pension system" suffers from serious structural problems.

- Coverage under China's basic pension system remains far from universal in the cities and has not yet been extended to the countryside.
- The current basic pension system labors under large unfunded liabilities inherited from the old SOE system—which means that contribution rates must be set at prohibitively high levels.
- Benefits under the system are not fully portable, confronting workers with a stark trade-off between job mobility and retirement security.
- The system's second tier of largely notional personal accounts earns such a low rate of return that it cannot possibly deliver promised benefits.

A four-step reform plan.

- **Step 1: Create a universal noncontributory floor of protection against poverty in old age.**
- **Step 2: Socialize the basic pension system's unfunded liabilities—that is, have the central government directly assume the cost.**
- **Step 3: Transform today's two-tiered basic pension system into a fully funded national system of publicly regulated but privately managed and invested personal accounts.**
- **Step 4: Expand supplemental coverage under China's new private “enterprise annuity” system.**

Key design choices in a National Personal Accounts System.

- **Structure of the system: “provident fund” model versus “Chilean” or Swedish” models.**
- **Crucial importance of an independent regulator to certify fund managers, establish investment guidelines, and police the system.**
- **Strict capital requirements, fiduciary obligations, and reporting rules for fund managers.**
- **Lifecycle portfolio allocation to protect workers nearing retirement against market downturns.**
- **Mandatory annuitization to protect against longevity risk once workers are retired.**

To implement the reform, China would have overcome considerable obstacles.

In the long run, however, the reformed system would cost far less than today's system and would bring vast social and economic benefits as China ages.



The social and economic benefits of reform.

- **The floor of protection would ensure that elders will no longer have to fear dependency and destitution—and may even avert social and political crisis in an aging China.**
- **The national system of personal accounts would allow a growing share of tomorrow's elderly to enjoy a comfortable retirement without imposing a crushing burden on tomorrow's workers.**
- **The system would also help China meet its long-term development goals by broadening and deepening capital markets and maintaining adequate rates of savings and investment as society ages.**
- **Along the way, it would turn most workers into stakeholders in China's long-term economic success.**



The decisions China makes today in retirement policy will go a long way toward determining whether it achieves its goal of becoming a prosperous developed economy.

